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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

18 DEC 1984

MEMORANDUM FOR: See Distribution List

FROM: [redacted] 25X1
Chief, Economics Division
Office of Global Issues

SUBJECT: LDC Inflation and LDC Foreign Investment Policies [redacted] 25X1

Attached are two typescript memos I think you may find interesting. The first examines some of the key causes and implications of greatly increased inflation rates in a number of troubled LDC debtors. The second presents a review of recent actions taken by LDCs to stimulate foreign investment or, in some cases, actions that are discouraging to potential investors. We welcome any questions or comments [redacted] 25X1

[redacted] 25X1

Attachments:

Troubled LDC Debtors: Accelerating Inflation
GI M 84-10233, December 1984 18DEC84

Developing Countries: Policy Shifts Toward Foreign Direct Investment
GI M 84-10234, December 1984 17DEC84

[redacted] 25X1

[redacted] 25X1

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SUBJECT: LDC Inflation and LDC Foreign Investment Policies

OGI/ECD/DI:[redacted]7 December 1984 [redacted] 25X1

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

17 December 1984

# Troubled LDC Debtors: Accelerating Inflation


## Summary

**Spiraling inflation threatens to stall the recoveries and seriously disrupt the economies of a number of debt-troubled developing countries. Inflation in Argentina and Brazil - now exceeded by Bolivia - has hit triple digit levels in most years since the late 1970s. We believe that large government budget deficits, cutbacks in the growth of foreign lending and the acceleration of monetary expansion in response to these developments have played a crucial role in the near runaway inflation in these countries.** 25X1

**In our view, inflation will continue to trouble a growing number of developing countries. In particular, severe chronic inflation poses a serious problem for governments in Argentina and Bolivia and may contribute to political unrest in Peru and the Philippines. Reversal of the recent downward trend in inflation also could threaten economic recovery and financial adjustment in Mexico.** 25X1


This memorandum was prepared by Development Issues Branch, Office of Global Issues. The information in this memorandum is updated through 12 December 1984. 25X1 25X1

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## Troubled LDC Debtors: Accelerating Inflation

### Accelerating Inflation

Consumer price inflation has become an acute problem in a growing number of developing countries (Table 1). For all non-oil LDCs as a group, GDP-weighted annual inflation rates increased from 25 percent in 1979 to 32 percent in the 1980-82 period to 44 percent last year. The worst hit by inflation include a number of key debtor LDCs. Bolivia leads the list with 1590 percent inflation for 12 months through October, followed by Argentina with 704 percent. Triple-digit inflation also persists in Brazil and Peru.

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### Underlying Factors

In our view, the inflation spiral now afflicting many LDCs had its roots during the recession of the early 1980s, when many LDCs ran huge government deficits in an effort to protect the real living standards of their people. Public sector expansion often continued into the recession even as government tax collections fell with declining economic growth. In Argentina, for example, government deficits during 1981-83 as a percent of GDP were triple those of the preceding four-year period (Table 2). Substantial deficit increases also burdened the economies of Bolivia, Brazil, Mexico, and the Philippines. [redacted] 25X1

Deficits continue to trouble many of these countries. Argentina has budgeted a deficit of nearly 10 percent of GDP for 1984. In Mexico, even with little planned increase in 1985 outlays, the government projects a somewhat higher budget deficit as a percent of GDP than was originally envisioned by the IMF. In Bolivia, the Embassy reports continuing government difficulty in



[redacted] 25X1

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Table 1

Recent Inflation Rates in
Key Debtor Countries*

| | | |
|---|---|---|
| Bolivia | (through October 1984) | 1590 |
| Argentina | (through October 1984) | 704 |
| Brazil | (through October 1984) | 211 |
| Peru | (through August 1984) | 104 |
| Mexico | (through November 1984) | 59 |
| Philippines | (through October 1984) | 64 |

*Annual percent change over preceding 12 months



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Table 2

Government Deficit as Percent of GDP in

Key Debtor Countries

Annual Averages, 1977-80 and 1981-83

| | 1977-80 | 1981-83 | Difference |
|---|---|---|---|
| Bolivia | -6.0 | -17.1* | -11.1 |
| Brazil + | -7.1 | -15.6 | -8.5 |
| Mexico | -3.1 | -10.2 | -7.1 |
| Argentina | -3.1 | -9.3 | -6.2 |
| Philippines | -1.1 | -3.3 | -2.2 |
| Peru | -3.9 | -3.9 | 0.0 |

* Data available for years 1981 and 1982 only.

\+ Public Sector Borrowing Requirement (PSBR), as (negative) percent of GDP, used here because Brazilian government budget must be formally reported to be in balance.



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formulating an economic program to deal with the deficit problem. 25X1

In many debt-troubled LDCs, neither foreign nor domestic lending could be mobilized in amounts sufficient to cover the ballooning deficits:

- **Foreign lending** growth to many developing countries slowed dramatically as lender banks began to question LDCs' ability to service their accumulating debt. According to the IMF, new commercial lending to non-oil LDCs fell from $41 billion in 1982 to $27 billion in 1983.

- **Domestic lending** could not meet the widening gap between constrained borrowing from abroad and the growing deficits. Economic recession constrained internal savings, while higher foreign interest rates and over-valued official exchange rates often led to large-scale capital flight. We estimate capital flight from Latin American LDCs may have exceeded $100 billion during 1979-83. 25X1

When borrowing could no longer support their government deficits, some debt-troubled LDCs resorted to inflationary financing through substantial increases in the domestic money supply. This sudden expansion of money and credit could not be absorbed through real economic growth, and domestic prices were forced up at a correspondingly rapid rate. Particularly sharp accelerations in monetary expansion have occurred in Argentina, Bolivia, Peru, and the Philippines; in each country, money stock growth has nearly tripled since late 1982. 25X1

<u>Current Developments</u>

There are few signs that monetary inflation in key debtor countries is likely to abate quickly:

- **Argentina**'s recent IMF accord calls for reductions in government deficits as well as money supply and inflation. The reluctance of the



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government to cut social programs will almost certainly keep the 1984 and 1985 public sector deficits above those forecast by the government. Likewise, pursuit of monetary discipline is complicated by the pervasive indexing of the Argentine economy and inflationary expectations. Wage adjustments in excess of targeted inflation have already raised IMF concern. Nonetheless, inflation slowed somewhat in October and November, and recent monetary tightening could dampen inflationary fires for the time being. [redacted] 25X1

o [redacted] the monetary expansion necessary to finance recent economic measures taken in **Bolivia** could push inflation to an annual rate of over 2000 percent by yearend. For example, the government has recently granted a 656 percent increase in the minimum wage to persuade the powerful labor organization to end its general strike. Many businessmen are telling US officials that massive wage hikes in the face of price controls are squeezing profits, stopping some production, and helping to bankrupt some businesses. 25X1

o Although **Mexico's** 1984 public sector deficit remains near 1983 levels, there has been a near doubling of the rate of monetary growth. With increases in the money supply and the government's commitment to stem the decline in real wages, we expect Mexico City to be unable to meet its 1985 inflation target of 35 percent.

o **Brazil's** attempts to tighten fiscal and monetary policies under its IMF accord have had little evident effect on inflation thus far. Brazil's highly indexed economy and inflationary expectations are keeping consumer price inflation above 200 percent for the second successive year. The Embassy reports that fighting inflation has



[redacted] 25X1

become the current military government's top economic priority, but it is too early to tell what positions might be taken by the new civilian government next year. Some Brazilian analysts predict that the civilian government's growth strategy could boost inflation to 250-to-300 percent. The presidential candidates of both the government's party and the opposition advocate dismantling the indexation system but concede that it will require considerable time to do so. 25X1

Implications

If permitted to proceed unchecked, continued upward spirals of money supply growth and price inflation can undermine the economic foundations of a society. Even at moderate annual rates, chronic inflation relentlessly dilutes the value of financial assets, fixed salaries, and other cash transfers. This induces consumers to spend quickly before prices rise and to live on borrowed money rather than saving funds of their own. Accordingly, the diminished levels of investment increasingly flow to speculative ventures at the expense of productive enterprise. As a result of these distortions, an economy becomes less productive and less efficient, economic growth falters, and economic inequality increases. The stronger the inflation and the longer its duration, the more severe are these effects. 25X1

In particular, the persistent and/or recurrent high inflation may present serious political and social challenges in several key LDCs. The failure to control monetary inflation in Argentina and Bolivia could produce prolonged economic chaos and increased political unrest. In both countries, economic demands of powerful labor organizations significantly impede government attempts to devise viable austerity programs and bring down government deficits. Moreover, labor unions and other important economic players appear to have diminishing confidence that their governments have workable plans for

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reducing inflation. Other countries that face political and social fallouts from inflation include Peru and the Philippines, where economic deterioration and existing political unrest reinforce each other, and Mexico, where social strains could intensify if living standards continue to fall. 25X1



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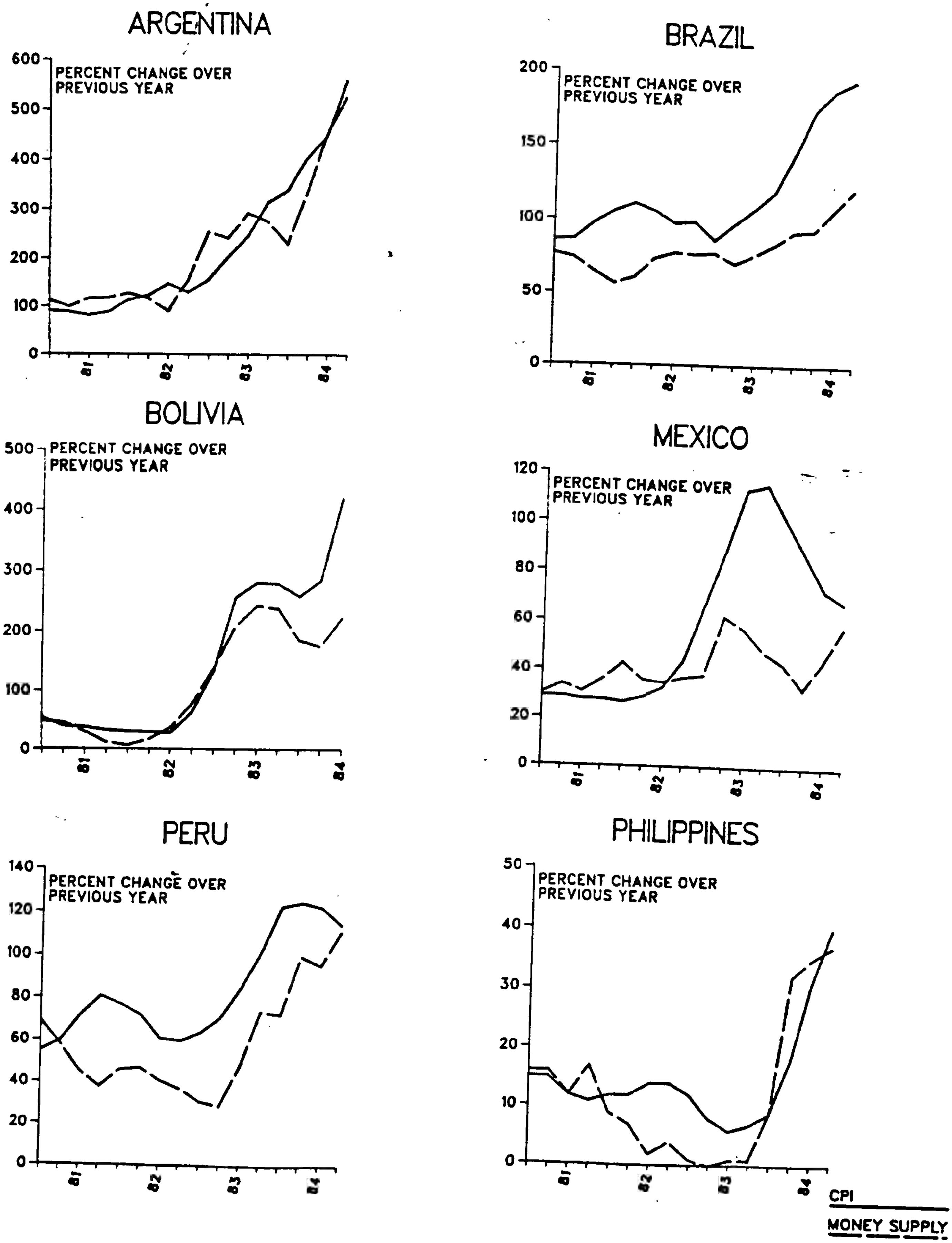
# TROUBLED LDC DEBTORS: RECENT TRENDS IN INFLATION AND MONEY SUPPLY



Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

17 December 1984

# Developing Countries: Policies Toward Foreign Direct Investment

## Summary

**We doubt that foreign direct investment will soon play a greater role in the total financial flows to developing countries, even though declines in commercial bank lending and aid will tend to heighten its importance. In a review of recent diplomatic and open-source reporting, we find that some countries -- for example South Korea, Chile, and Jordan -- are taking new action, or considering taking new action, to encourage foreign direct investment. However, often for political or tax-raising purposes, nations such as Mexico and the Philippines are taking steps discouraging to foreign investors. Given the continued importance placed on such non-economic issues by governments, we believe that most developing countries will avoid making substantial policy shifts favoring foreign investment over the near term.** 25X1

This memorandum was prepared by Development Issues Branch, Office of Global Issues. The information in this memorandum is updated through 12 December 1984. 25X1

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## DEVELOPING COUNTRIES: POLICIES TOWARD FOREIGN DIRECT INVESTMENT

### SOME COUNTRIES TAKE POSITIVE ACTIONS

Most of the developing countries that have recently taken steps to attract more foreign investment have granted special incentives to attract new capital and technology into targeted areas. 25X1

South Korea liberalized its foreign investment policy in July by revising the Foreign Capital Inducement Law. The revised law opens up the computer and robotics industries to foreign participation, eases restrictions on remittances, and streamlines the approval process for investments in which the foreign partner holds a minority share. We judge these new rules reflect Seoul's belief that foreign direct investment will enhance long-term growth by introducing advanced technology into the country. 25X1

Chile is attempting to reverse the 60 percent reduction in foreign direct investment in 1983 by improving its already liberal investment policy, according to the US Embassy. For example, earlier this year a new mining code was enacted which places constraints on expropriation and gives foreign owners the same rights as natives to buy and sell mineral concessions. In addition, steps have been taken to establish overseas promotion missions to attract new foreign investors. 25X1

According to press reports, Jordan now has legislation in place whereby foreign direct investment in approved projects will be exempt from customs

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duties on machinery and spare parts. Some income tax relief also has been granted to foreign investors, with greater tax savings if the investment is made outside Amman. As specified in this legislation, proposed projects that use local capital and labor and introduce foreign technology are most likely to be approved. [redacted] 25X1

The US Embassy reports that the government of Zaire is planning to publish a revised investment code in the near future. The new code provides for tax exemptions on imports and exports, property, corporate earnings, and expatriate salary transfers for new or expanded foreign investment. [redacted] 25X1

A policy paper to be presented to Kenya's cabinet by the end of the year will recommend new incentives for foreign investors, according to press reports. Proposed new incentives include exemptions from duty and sales taxes on equipment purchases by foreign investors and a five-year tax holiday if the investment is in the agro-processing, export manufacturing, or fishing sector. If the proposed policy is approved, changes in the Foreign Investment Protection Act are likely to be legislated in 1985. [redacted] 25X1

Although Andean Pact countries are formally bound by a treaty agreement that establishes unified foreign investment regulations, Ecuador, Colombia, and Peru have recently relaxed these regulations to attract additional foreign capital. Quito has already eased profit repatriation and ownership rules, Bogota has offered tax breaks for export-oriented firms and liberalized controls on profit remittances, and Lima has doubled remittance allowances. The other members of the pact, Venezuela and Bolivia, have taken no action, although Caracas would grant new incentives if the treaty is modified, according to the US Embassy. [redacted] 25X1

[redacted] 25X1

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OTHERS REDUCE INCENTIVES

While we find few developing countries actively working to attract new foreign direct investment, a number of countries actually have taken actions discouraging to foreign investors. These actions often have been driven by concerns over foreign economic domination or a need to raise tax revenues. 25X1

Mexico recently enacted decrees applicable to the automotive, electronics, and pharmaceutical industries which tighten state controls of the manufacturing and marketing activities of foreign-owned firms. These actions were apparently motivated by fear of foreign economic domination in these industries. Mexico sometimes has been willing to grant exemptions to controls for investment in export-oriented firms and to acquire new technology. For example, Ford late last year secured an agreement for a \$500 million assembly plant, receiving both financial incentives and an exemption from local ownership controls. In another case, however, IBM's attempt to reach a similar agreement involving a facility to produce personal computers might fall through, according to press reports. Despite some cases where exemptions have been granted, we believe that traditional Mexican concern about the risks of foreign investment will generally result in maintenance of tight state controls. 25X1

Under an IMF-supported restructuring of the tax system, designed to increase revenues, the Philippine Board of Investment recently rescinded all tax and duty incentives given to regional headquarters of foreign companies. Since headquarters offices usually have few fixed assets, largely business machines and computers, these offices can be moved

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relatively easily. Hence, we believe some firms may consider moving their regional headquarters to nearby locations that continue to grant such incentives, namely Singapore and Hong Kong. 25X1

Changes in Indonesian laws are causing investor concern. Although new tax laws enacted earlier this year increase depreciation allowances and should prove beneficial to foreign-owned businesses in the long run, the elimination of tax holidays has led to an immediate decline in new investment applications, according to the US Embassy. A new law requiring unions in foreign-owned firms has led one company official to say he will recommend to corporate headquarters that plans for future investment be halted. These changes have produced uncertainty about Jakarta's future actions concerning foreign investment policy, adding to the negative impact. 25X1

OUTLOOK

Over the near-term, increases in foreign direct investment in most developing countries will continue to be limited by tight state controls and depressed economic conditions. Despite pockets of change, we believe most developing countries will continue to be reluctant about actively encouraging foreign direct investment on a substantial scale. Considerations other than the benefits of foreign investment -- such as fear of foreign economic domination or a desire to protect a domestic industry -- will continue to dominate the views of many of these countries. Secondly, apart from the role of foreign investment policies, success or failure in attracting investment will still depend upon other factors, including the economic growth outlook of the country, exchange rate and

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trade policies, and political stability. In countries such as Chile facing low economic growth, foreign exchange problems, and political unrest, the overall investment climate will restrict new ventures even with substantial changes in investment incentives. 25X1

Moreover, the relatively small scale of foreign direct investment suggests that in general developing countries will have to look to other remedies for managing the recent cutbacks in bank lending and other capital flows (Figure 1), even if foreign direct investment increases. Since 1970, according to OECD data, foreign direct investment in developing countries has averaged about $12 billion per year, with no noticeable trend either up or down. In the meantime, other financial flows fell by about $21 billion in 1982. Thus, even a doubling of foreign investment would only offset roughly half of the decline in these other sources of capital. 25X1

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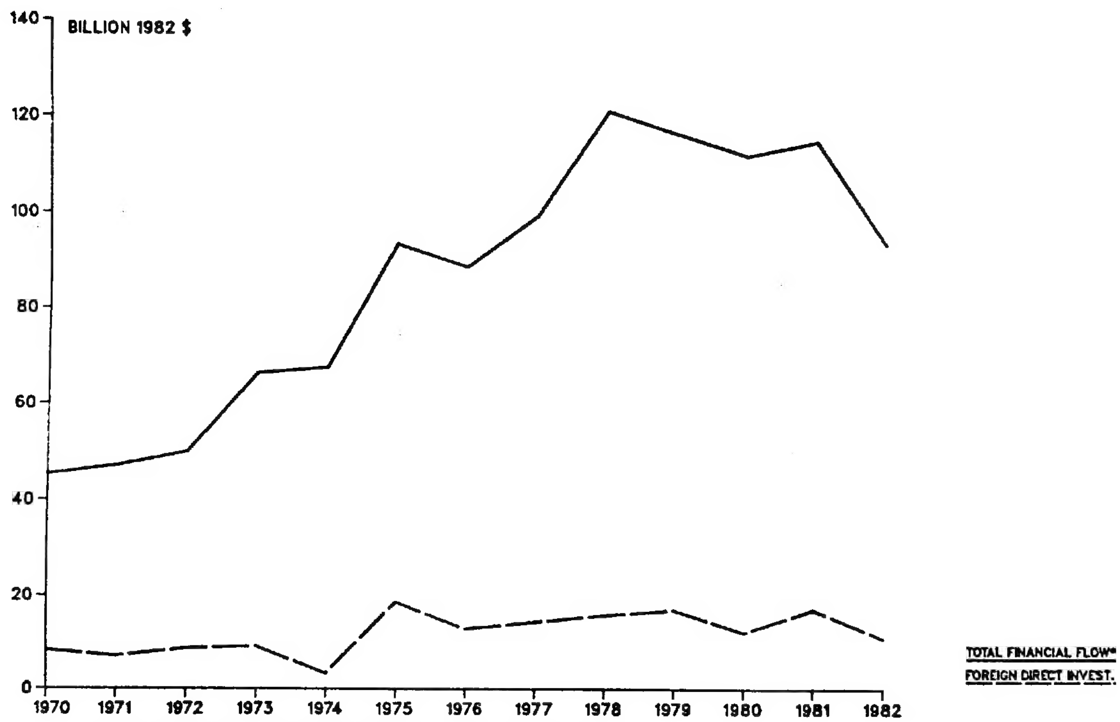
FIGURE 1

# DEVELOPING COUNTRIES: ROLE OF FOREIGN INVESTMENT




* TOTAL FINANCIAL FLOW IS THE SUM OF OFFICIAL DEVELOPMENT ASSISTANCE, EXPORT CREDITS, BANK LOANS, FOREIGN DIRECT INVESTMENT, AND OTHER FLOWS.
SOURCE: OECD

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